CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: RULES COMMITTEE

FROM: Leslye Corsiglia

SUBJECT: AFFORDABLE HOUSING RISK ANALYSIS WORKLOAD ASSESSMENT

DATE: October 14, 2004

Approved

Date 10.14.04

RECOMMENDATION

It is recommended that the Rules Committee review the workload analysis.

BACKGROUND

On September 29, 2004, Councilmember Reed requested that the Rules Committee place a discussion of a risk analysis of affordable housing transactions on the October 26, 2004 Council Agenda. This memorandum responds to that request.

ANALYSIS

The City's Housing Department is responsible for administering the City's affordable housing programs, including the multifamily housing production program. The City's production program is the largest in California, and has, in recent years, out-produced all other top ten California cities combined. In June, the City celebrated the completion of over 6,000 units of newly affordable housing in a five-year period. The City's $250 million commitment over this time period was matched with more than $1 billion in bonds, conventional loans, other public funding and equity contributions. Since the inception of the Housing Department in 1988, the City has invested approximately $635 million in affordable housing projects leveraging an additional $2 billion.

Local Government Role

Local government plays an integral role in the production of affordable housing. Without public dollars, few private lenders or developers would take the risk to develop affordable housing—which restricts profit, caps rents that can be charged, and has significant legal and regulatory restrictions that complicate the financing package. Typically, an affordable housing project has the involvement of six of more lenders. Additionally, most other funding sources, including bond financing and tax credits, provide strong incentives for developers to obtain local government funding. Some State programs require a local government match.

Local public agencies, such as the Housing Department, are considered "gap" lenders-- they fill the funding gap between the cost of developing an affordable project and the amount of funds that are made available through private mortgages, tax credit equity and other loans and grants. Local funds are the first that must be committed to a project in order to demonstrate to other public lenders, private investors and public agencies that a project is likely to prove financially feasible and is supported by the community.

Local housing finance agencies provide various types of subordinate loans to affordable housing projects, at various stages of the development process, depending on the particular financial structure of each project. For example, local public agencies frequently provide loans to pay for predevelopment expenses while the project is progressing through the entitlement, design and pre-construction process; acquisition loans for payment of raw land or buildings to be demolished or rehabilitated; loans for payment of construction expenses; and, "permanent" loans, with repayment spread over a 30 to 40 year period, for the long term financing of the project. **Each of the different types of public loans presents different risks which are mitigated with different legal and financial structures.**

In addition to the risks associated with the type of loan the City may make to a developer, there may be risks involved due to other lender requirements, and the type of project being proposed (including mixed-use developments), among others.

The funds provided by the City for new affordable housing development are in the form of "subordinate" loans repayable through surplus income generated by the operations of the project, after all ongoing operating expenses, debt payments and partnership fees are paid. A loan is "subordinate" if it has lesser rights related to repayment and foreclosure than more senior lenders and investors. Specifically, in the case of default and foreclosure, a senior lender has the right to extinguish lesser obligations unless a subordinate lender elects to "cure" by paying any due amounts or by performing an obligation of the borrower.

As a rule, senior lenders and investors require local housing finance agencies, such as the Housing Department, to subordinate their loans in order to enhance the security of their debt and equity contributions. Because the City's funds are "soft debt" (i.e., will only be repaid after all other "hard debt" obligations), lenders are willing to participate in affordable housing projects. In addition, because the City's loans are soft debt, the conventional lenders discount the repayment obligation of the soft debt and are willing to provide larger loans than they otherwise would, thereby reducing the funding gap and the amount of funds that the City might have to contribute to the project.

Request for Risk Analysis Discussion

We can respond to the questions posed in Councilmember Reed's September 29, 2004 memorandum, though the subject, due to its complicated nature, is not one that easily lends itself to a formal discussion at a Council meeting. We would suggest instead that the Housing Department be directed to respond to the questions that Councilmember Reed has posed in an information memo to the City Council. Should any member of the City Council have a question or concern about specific policy issues that come from that memo, the Department could be asked to prepare a report on a more narrow subject. As mentioned earlier, the amount of risk that the City has with any one transaction is dependent on the type of financing provided, the requirements of other lenders, and the specific features of each development itself. The subject of affordable housing lending is complex. Discussing this topic at a formal meeting and ensuring that it is understandable to the general public would be quite challenging.

To prepare a thorough memorandum that responds to the questions included in the memorandum would require coordination between the Housing Department, the Finance Department, and the Office of the City Attorney. Some of the questions, such as who has the authority to increase the loan after the loan agreement has been executed, are easily answered. Others, such as how the loan is repaid, are more complicated and dependent on a number of factors. To thoroughly respond, we estimate that this risk analysis would take between 50-80 hours of staff time between the three departments. In addition, the Housing Department would utilize the services of the City's Financial Advisor, Ross Financial, to assist in the preparation of a risk analysis, based on the existing scope of services and corresponding compensation schedule. We estimate that this would require $2,000.00 in consultant compensation.

In summary, we recommend an information memorandum to the City Council as a first step. Should that information memorandum not sufficiently respond to the City Council's questions, the item could then be placed on the City Council agenda. Should the Rules Committee decide that it be placed on an agenda, we request that it be in November to give City staff the time that it will take to thoughtfully respond to this request for information.

COORDINATION

This memorandum has been coordinated with the City Attorney's Office, the Finance Department, and the City Manager's Office.

LESLYE CORSIGLIA
Director of Housing

RULES COMMITTEE: 10-27-04
ITEM: G1

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

Chuck Reed

TO: Rules Committee

FROM: Chuck Reed

SUBJECT: **Risk analysis of affordable housing transactions**

DATE: September 29, 2004

AGENDA REQUEST:

I request that the following item be placed on the Council agenda for discussion and action on October 26, 2004:

Discussion and action on the risks the city undertakes when it participates in the development of affordable housing projects.

BACKGROUND:

Our affordable housing program has been a great success with over 6000 units developed in the last few years. We have successfully participated in hundreds of successful projects. Our ability and willingness to be the gap lender to provide financing to bridge the gap between developer equity and other financing has been crucial to our success.

However, as land values and construction costs continue to rise, we may be called upon to increase our participation in order to make new projects viable. If we do so, the risk of loss also increases. How much risk we take and the way we participate in such deals should be reconsidered occasionally outside of the context of any specific deal.

When this item comes to the Council, I will have some specific questions, such as:

1. What is the difference between a gap lender and an equity partner or an equity lender?
2. Do we have limits on the percentage of financing we will provide?
3. Do we have a minimum percentage of equity contribution required from the developer?
4. Do we have a limit on how much money the developer can take out of the project in fees?
5. How do we make sure the developer has enough money to finish the construction if problems arise?
6. If the developer does not have enough money to complete a project, are we obligated to contribute more money?
7. If our contribution increases, do we get any additional return, such as a share of the profits?
8. Does anyone other than the Council have the authority to promise to put additional money into a deal after the loan agreement is executed?
9. How do we get our loan repaid?
10. If the developer defaults during construction or the operator defaults later, can we foreclose on the property without paying off the other lenders?

Cc Lee Price, Clerk